Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM 1994

FIDELITY AND DEPOSIT COMPANY OF MARYLAND

Petitioner,

vs.

THE UNITED STATES OF AMERICA

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. Whether the Fifth Circuit erred in creating new common law that the general principals of commercial suretyship law have no applicability to a surety for distilled spirits excise taxes.

2. Whether the Fifth Circuit erred in creating new common law that under no circumstances, regardless of how egregious, can the United States be estopped to collect on a distilled spirits bond.

3. Whether the designation of a distilled spirits bond as both a "withdrawal" bond and a "unit" bond results in the designation of the bond as a "withdrawal" bond being mere surplusage under the federal statutory scheme set out in 26 U.S.C. § 5173.

INTERESTED PERSONS

PETITIONER

Fidelity and Deposit Company of Maryland which is wholly owned by F & D Holding Corporation which in turn is owned by Swiss Re Holding (North America) Inc., New York, New York and Zurich Insurance Company, Zurich, Switzerland.

The bonds at issue in the underlying case were secured by a letter of credit issued by American Bank, a Texas State Bank.

Petitioner is represented by Stephen W. Schueler and Linda D. King of Winstead Sechrest & Minick P.C. of Houston, Texas.

RESPONDENT

United States of America. Respondent is represented by Gary R. Allen, John A. Dudeck, Jr. and Linda Mosakowski of the Department of Justice, Tax Division.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit is reported at 10 F.3rd 1150 (5th Cir. 1994) and is reproduced as Appendix A. Rehearing was denied and a copy of the Order Denying Rehearing is reproduced as Appendix B. The unpublished opinion of the District Court for the Southern District of Texas which granted summary judgment for the United States is reproduced as Appendix C. The order of the District Court Amending the Summary Judgment is reproduced as Appendix D.

JURISDICTION

The judgment of the Court of Appeals was entered on January 7, 1994. (App. A). Rehearing was denied February 7, 1994 (App. B). This Petition for Writ of Certiorari was filed within 90 days of that date. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTES INVOLVED IN THIS CASE

This case requires consideration of the following statutes and regulations, the full text of which are set forth in Appendix "E" hereto:

26 U.S.C. § 5173
26 U.S.C. § 6103
27 C.F.R. Alcohol, Tobacco & Firearm § 19.519

STATEMENT OF THE CASE

Bay River Company, Inc. ("Bay River") operated a bottling facility in Bayside, Texas. In order to comply with federal statutes governing distillers, Bay River obtained a distilled spirits bond from Fidelity & Deposit Company of Maryland ("Fidelity & Deposit") issued October 5, 1984 (the "1984 Bond"). The total amount of the 1984 Bond was $350,000.00 which was designated on the back of the bond form as being $250,000.00 of withdrawal coverage and $100,000.00 of operations coverage. On the front of the bond form are printed boxes to be checked to indicate the "type of bond prescribed under 26 U.S.C. § 1573." Boxes for "withdrawal bond" and "unit bond" are checked; however the box for "operations bond" is not.

At all times relevant the Bureau of Alcohol, Tobacco and Firearms ("ATF") assessed taxes and enforced the regulations governing distilleries. The actual collection of the excise taxes was handled by the Internal Revenue Service ("IRS"). If a distiller failed to pay its taxes when due, the IRS would notify the ATF which would commence enforcement actions.

From the beginning of its operations in November 1984, Bay River failed to comply with the federal regulations governing distillers. An ATF audit for the period November 1984 to June 1985 revealed numerous violations, including Bay River's failure to properly calculate and timely pay its taxes. As a result of these violations the auditor recommended that, "The proprietor's tax payments should be carefully monitored. Any late filing or payment should trigger an immediate investigation with further action appropriate to the situation."

As early as October 1985, Bay River began issuing a series of checks to pay its excise taxes that were returned unpaid to the IRS after being dishonored by the bank. The IRS regulations in effect during that time required that the service center manager of the IRS immediately call the ATF Chief of Technical Services to inform him of the dishonored check; that telephone call would be followed with a bill for

collection (designated as Optional Form 1114) which was sent to the taxpayer along with the dishonored check, with a copy to the Regional Director of ATF.

If the taxes were not paid within 30 days the IRS would send a second copy of the bill for collection to the ATF marked "unpaid". This procedure assured that the ATF would receive 3 notifications from the IRS of each dishonored check; i.e. a phone call and two copies of the bill for collection sent at 30 day intervals.

The Code of Federal Regulations, Alcohol Tobacco and Firearms, require that when the ATF was notified that a taxpayer's check had been returned unpaid, it was to place the taxpayer on a cash prepayment basis until all defaults were cured and a determination made that the revenue would not be jeopardized by acceptance of a check. 27 C.F.R. § 19.519 (1986). On February 4, 1986 the ATF placed Bay River on prepayment status. The ATF's written notification to Bay River instructed that all future taxes were to be paid in cash or by cashier's check prior to any withdrawals. Contrary to the regulations, the Regional Director of Compliance for the ATF, orally agreed to allow Bay River to continue to pay its excise taxes by company check even though Bay River owed in excess of $100,000.00 in back taxes at that time. On February 13, 1986 the ATF was notified by the IRS that another of Bay River's checks had been returned unpaid, but still, the ATF did not enforce the prepayment requirement.

The ATF conducted a second audit of Bay River covering the period of July 1, 1985 through March 6, 1986. This audit revealed that Bay River's excise taxes were not being accurately determined or timely paid and that Bay River was not complying with the tax prepayment requirement. At the time of the second audit Bay River's overdue tax liability for returned, unpaid checks was in excess of $441,346.91. Although Bay River's unpaid tax liability had continued to increase, the ATF did not enforce the prepayment requirement (even though Bay River was still on prepayment status) or make demand against the 1984 Bond. The second audit

recommended that Bay River obtain a strengthening bond to cover its tax obligations.

Between April and June of 1986 the ATF wrote to Bay River four times about its failure to timely file its tax returns and warning that continued failure to comply with the tax laws and regulations could result in action being taken against its permit.

Finally, in October 1986, the ATF wrote to Bay River that because Bay River's checks were being returned unpaid to the IRS, it was withdrawing the earlier agreement to allow payment by company checks and that all future excise taxes would have to be paid in cash prior to withdrawals. Contrary to this letter, however, the ATF still did not enforce the prepayment requirements set forth in the Code of Federal Regulations. By this time Bay River's unpaid tax liability was in excess of $600,000.00.

The ATF took no action with respect to the delinquent taxes owing from Bay River even though part of the tax liability was more than a year old. The ATF did not make demand against the 1984 Bond, enforce the prepayment requirement or revoke Bay River's permit. Bay River continued to write company checks for payment of its excise taxes which were subsequently returned unpaid. As a result, its delinquent tax liability increased to $821,221.64.

Following the ATF's suggestion in the second audit, Bay River requested a strengthening bond from Fidelity & Deposit. In November, 1986 Fidelity and Deposit issued a second bond (the "Strengthening Bond"), totally unaware that Bay River owed in excess of $800,000.00 in unpaid past due taxes and had been placed on prepayment status. The Strengthening Bond increased Fidelity and Deposit's potential liability by an additional $600,000.00 for withdrawal coverage. Although the ATF was fully aware of Bay River's existing defaults, the ATF approved the Strengthening Bond without comment. Subsequent to the issuance of the Strengthening Bond, Bay River wrote bad checks for the payment of taxes which resulted in additional tax liability in

excess of $600,000.00 for which the Government sued Fidelity and Deposit.

The ATF took no enforcement action with regard to Bay River until 1988 when the principal of the company voluntarily came in to discuss the tax liability which, by then, was in excess of $1,000,000.00. When the principal indicated that he was going to liquidate Bay River, ATF made demand on Fidelity and Deposit for the full amount of the 1984 Bond and the 1986 Strengthening Bond.

ARGUMENTS FOR GRANTING THE WRIT

I. THE STRENGTHENING BOND IS A CONTRACT BETWEEN FIDELITY AND DEPOSIT AND THE GOVERNMENT WHICH SHOULD BE GOVERNED BY THE PRINCIPLES OF COMMON LAW RELATING TO SURETYSHIP; HOWEVER THE COURT OF APPEALS DETERMINED THAT BECAUSE THOSE PRINCIPLES ENCOMPASS ELEMENTS SIMILAR TO ESTOPPEL, THE COMMON LAW OF SURETYSHIP DOES NOT APPLY.

The liability of Fidelity and Deposit should be determined under the basic common law principles governing all commercial sureties. Among those is the principle that:

> Where, before the surety has undertaken his obligation the creditor knows facts unknown to the surety that materially increase the risk beyond that which the creditor has reason to believe the surety intends to assume, and the creditor also has reason to believe that these facts are unknown to the surety and has a reasonable opportunity to communicate them to the surety, failure of the creditor to notify the surety of such facts is a defense to the surety.

Restatement of Security § 124 (1941).

The Court of Appeals for the Fifth Circuit applied these principles in *St. Paul Fire & Marine Ins. Co. v. Commodity Credit Corp.*, 646 F.2d 1064 (5th Cir. 1981) and held that the government's failure to disclose material facts to the

sureties concerning the principal's defaults between the time a first bond was issued and a subsequent bond was issued relieved the sureties from liability on the subsequent bond.

In the instant case the Court of Appeals held, without explanation, that *St. Paul Fire & Marine* does not apply to cases involving surety bonds for excise taxes. They further stated that this case should be governed by *Hart v. United States*, 95 U.S. 316, 24 L.Ed 479 (1877) and *United States v. Fulton Distillery, Inc.*, 571 F.2d 923 (5th Cir. 1978) which were cases in which the sureties were seeking to estop the Government from collecting on bonds because of the negligence of government employees in not taking action against the principal quickly enough. Neither *Hart* nor *Fulton Distillery* involved a surety who issued a second bond in reliance on the creditor's failure to disclose material facts.

In *Hart* the surety argued that he should be relieved from his obligation under the bond because the Collector of Internal Revenue, either through negligence or malfeasance, had allowed distilled spirits to be removed from the distillery without first collecting the required tax. This Court disagreed and stated:

> Here the surety was aware of the lien which the law gave as security for the payment of the tax. He also knew that, in order to retain this lien, the Government must rely upon the diligence and honesty of its agents. If they performed their duties and preserved the security, it inured to his benefit as well as that of the Government; but if by neglect or misconduct they lost it, the Government did not come under obligations to make good the loss to him, or what is the same thing release him pro tanto from the obligation of his bond. As between himself and the Government, he took the risk of the effect of official negligence upon the security which the law provided for his protection against loss by reason of the liability he assumed.

Id. at 95 U.S. 318-319.

In *Fulton Distillery* the surety sought to be relieved from its bond obligation because of an eight week delay between the time the IRS first received a dishonored check for the

payment of excise taxes and the time it notified the ATF. The surety argued that the Government owed an implied duty to the surety to put the distiller on prepayment immediately upon learning of the dishonored check and that the eight week delay was a result of negligence which should estop the Government from collecting on the bond. The Court of Appeals, relying on the decision in *Hart*, ruled that the surety by contracting with the Government had accepted the risk of loss attributable to a governmental employees' negligence. *Id.* 926.

The surety in *Fulton Distillery* also argued that it should be relieved from liability because the government's delay in putting the distiller on prepayment increased the risk of loss beyond that for which the surety had contracted. The Court of Appeals did not, as it has in this case, hold that suretyship principles do not apply, but rather ruled that the surety accepted the risk of loss when it issued the bond and nothing the government did after that time could increase that risk. *Id.* at 928.

The Court of Appeals has taken the position in this case that because the contractual principles governing suretyships have some of the same elements as estoppel, those principles do not apply to bonds to secure the payment of excise taxes. That same reasoning was rejected by this Court in *Lyng v. Payne*, 476 U.S. 926, 106 S.Ct. 2333, 90 L.Ed.2d 921 (1986). In *Lyng* the District Court had granted an injunction requiring the Farmers Home Administration (FmHA) to reopen an emergency loan program on the grounds that FmHA had violated its own regulations and failed to give adequate notice of eligibility requirements to participate in the loan program. The Secretary of Agriculture argued on appeal that the relief granted by the District Court shared all of the essential characteristics of an estoppel against the Government and the case should have been analyzed on those terms. The Court of Appeals rejected that argument and this Court agreed stating:

> As the Court of Appeals correctly observed, however, respondents' inability to satisfy the stringent requirements of common-law estoppel does not independently

> decide the case. . . . It may well be that some of the same concerns that limit the application of equitable estoppel against the Government bear on the appropriateness of awarding other remedies that have a close substantial resemblance to an estoppel. We reject, however, petitioners' suggestion that any remedy that can be analogized to an equitable estoppel is necessarily invalid, regardless of the source of the cause of action, unless the plaintiff succeeds in proving all the elements of common-law estoppel.

Id. at 476 U.S. 936, 106 S.Ct. 2340.

Fidelity and Deposit does not dispute the holdings of *Hart* and *Fulton Distillery*. It acknowledges that it accepted the risk of government negligence when it issued the 1984 Bond and has paid its obligation under that Bond. What distinguishes this case from *Hart* and *Fulton Distillery* are the actions of the ATF subsequent to the issuance of the 1984 Bond and prior to the acceptance of the Strengthening Bond by the ATF.

The facts in this instance are undisputed. Prior to approving the Strengthening Bond, the ATF was aware that (i) Bay Rivers' checks for payment of excise taxes were being returned unpaid; (ii) Bay River was insolvent; (iii) Bay River had been "fund floating" (i.e., submitting unpaid accounts receivable to the bank for cash loans to enable it to cover the company checks for taxes); (iv) Bay River was in default of its tax obligations; (v) Bay River was selling its product at a loss; (vi) Bay River's internal record keeping practices were inadequate; and (vii) there was inadequate voluntary compliance on Bay River's part, with the laws and regulations. Any one of the facts would materially increase the risk of loss to Fidelity and Deposit if it issued the Strengthening Bond and in combination would make a loss almost a certainty. No surety would have increased its bond obligation if it knew that the principal already owed $800,000.00 in unpaid taxes. The ATF's failure to disclose the facts known to it resulted in Fidelity and Deposit issuing the $600,000.00 Strengthening Bond upon which the Government is seeking to collect.

The Court of Appeals notes in its Opinion that the ATF may have been prohibited by 26 U.S.C. § 6103 from disclosing taxpayer return information to Fidelity and Deposit. Assuming *arguendo* that the ATF was prohibited from revealing information concerning Bay River's financial condition, nothing in the federal statutes prohibit the ATF from notifying the surety when the taxpayer defaults in the payment of its tax obligations. The ATF could have made demand on the 1984 Bond, enforced the prepayment requirement, or refused to approve the Strengthening Bond. Instead, the ATF recommended to Bay River that it obtain a strengthening bond even though its own audit concluded that Bay River was financially incapable of paying its taxes.

In their Opinion, the Court of Appeals states that "commercial expectations have been satisfied" by refusing to estop the government because "since *Hart* in 1877, sureties have been on notice that they assume the risk of governmental neglect in the collection of excise taxes." They go on to say that the surety could charge a higher fee to compensate for governmental neglect or engage in more active monitoring of the principal. This statement totally ignores the true "commercial expectations." The undisputed evidence is that Fidelity and Deposit would not, for any amount of fee, have issued the Strengthening Bond if it had been aware that Bay River was already in default under the 1984 Bond due to unpaid taxes in excess of $800,000.00. Commercial expectations would dictate that the Government would have taken some action to collect unpaid taxes which it knew had been owing for more than a year. Commercial expectations would also dictate that when the Government learned that Bay River was not paying its taxes it would have attempted to limit the potential loss to the treasury rather than giving permission to Bay River to violate the federal regulations.

Likewise, the statement that Fidelity and Deposit could have protected itself by more closely monitoring Bay River completely ignores the undisputed fact that it was the action of the Government that made it possible for Bay River to hide its financial condition, not only from Fidelity and

Deposit but from the bank from which Fidelity and Deposit sought information. When the IRS received a check that was dishonored by the bank it did not bring action on the check, or even redeposit it, rather it returned the *original* check to Bay River. At the time Fidelity and Deposit issued the Strengthening Bond in 1986, the IRS had returned 14 original checks totalling more than $800,000.00 to Bay River.

Had the IRS redeposited the checks that were dishonored the bank would have been put on notice that there was a problem. Because the checks were returned to Bay River, however, it was able to hide the fact that it owed in excess of $800,000.00 in taxes. Further, the bank like the IRS, was prohibited by Texas law from revealing information concerning its customers to third parties.

The ATF had adequate opportunity to disclose to Fidelity and Deposit the increase in the risk of loss that had occurred between the issuance of the 1984 Bond and the acceptance of the Strengthening Bond in November, 1986 but failed to do so. The ATF had written numerous letters to Bay River threatening to take action against its permit, but repeatedly refused to act. Under the principles governing surety[illegible] and the Court of Appeals' decision in *St. Paul Fire & Marine*, Fidelity and Deposit should be relieved from its liability on the Strengthening Bond.

II. THE COURT OF APPEALS' RULING THAT THE GOVERNMENT MAY NEVER BE ESTOPPED FROM COLLECTING ON EXCISE TAX BONDS DUE TO NEGLECT OR MISCONDUCT REGARDLESS OF HOW EGREGIOUS THE CIRCUMSTANCES, CREATES NEW FEDERAL COMMON LAW WHICH SHOULD BE RULED ON BY THIS COURT

The Court of Appeals held in this case that the Government may never, regardless of the circumstances, be estopped from collecting on a bond for excise taxes. App. A at p. 10. This Court has consistently refused to establish a hard and fast rule relating to estopping the Government. The Court of Appeals established the "no estoppel" rule

based on the decision in *Hart v. United States*, 95 U.S. 316, 24 L.Ed. 479 (1887) in which the Court stated that a surety accepts the risk of governmental negligence or misconduct when it issues a bond for excise taxes. Fidelity and Deposit agrees that it accepted that risk when it issued the 1984 Bond. What distinguishes this case from *Hart* and what the Court of Appeals failed to address, is that Fidelity and Deposit would not have issued the Stengthening Bond in 1986 had it known that Bay River already owed in excess of $800,000.00 in unpaid taxes or that the ATF had violated, and had allowed Bay River to violate, the federal regulations concerning the payment of excise taxes.

The vast majority of the decisions of this Court during the past 25 years in which estoppel against the Government has been discussed, have been cases where a private litigant was seeking to estop the Government from applying a statute or regulation as written based on the representations of a Government agent. *See, e.g., Reno v. Catholic Social Services,* 61 U.S.L.W. 4652, 113S.Ct. 2485, 125 L.Ed.2d 38 (1993); *Office of Personal Management v. Richmond,* 496 U.S. 414, 110 S.Ct. 2465, 110 L.Ed.2d 387 (1990); *Heckler v. Community Health Services of Crawford County, Inc.,* 467 U.S. 51, 104 S.Ct. 2218, 81 L.Ed.2d 41 (1984); *United States Immigration and Naturalization Service v. Hibi,* 414 U.S. 5, 94 S.Ct. 19, 38 L.Ed.2d 7 (1973). In each instance this Court has refused to find that the Government is estopped from applying the law as written. As stated in *Office of Personnel Management v. Richmond:*

> We recognize that "not even the temptations of a hard case" will provide a basis for ordering recovery contrary to the terms of the regulations, for to do so would disregard "the duty of all courts to observe the conditions defined by Congress for charging the public treasury."

110 S.Ct. at 2469, *quoting, Federal Crop Insurance Corporation v. Merrill,* 332 U.S. 380, 858-6, 68 S.Ct. 1, 3-4 92 L.Ed. 10 (1947).

In this case, Fidelity and Deposit is not seeking relief contrary to the terms of any regulation or statute. The relative rights and liabilities of Fidelity and Deposit and the Government are established pursuant to contract not statute. If the ATF had not accepted the Strengthening Bond, Fidelity and Deposit would have no liability beyond the 1984 Bond regardless of the amount of the taxes Bay River owes. Likewise, if the ATF had made demand on the 1984 Bond or had complied with or enforced its regulations, Fidelity and Deposit would not have issued a second bond.

The federal courts have held that to establish estoppel against Government one must prove the following elements: (1) that the party to be estopped was aware of the facts, (2) that the party to be estopped intended his act or omission to be acted upon, (3) that the party asserting estoppel did not have knowledge of the facts, (4) that the party asserting estoppel reasonably relied on the conduct of the other to his substantial injury; *Moody v. United States,* 783 F.2d 1244 (5th Cir. 1986), and (5) that the Government agents engaged in affirmative misconduct. *United States Immigration and Naturalization Service v. Hibi,* 414 U.S. 5, 38 L.Ed.2d 7, 94 S.Ct. 19 (1973).

Prior to the time that Fidelity and Deposit issued the Strengthening Bond, the ATF was aware: (i) that Bay River's record keeping procedures were inadequate to give any assurance that the excise taxes were being properly calculated or determined; (ii) that Bay River was insolvent and was fund floating; and (iii) that Bay River had repeatedly violated the regulations governing the operation of the distilled spirits plant. Further, IRS procedures provided the ATF with 42 separate notices that Bay River's checks had been returned unpaid and that Bay River owed delinquent excise taxes.

Second, the party to be estopped must have intended his act or omission to be acted upon. The evidence is undisputed that the ATF hoped to shift the loss to Fidelity and Deposit. The ATF's First Audit, which discovered that Bay

River was exceeding its $100,000.00 withdrawal bond coverage, stated that:

> We conclude that in case of default it is likely that action against the surety will be the Bureau's only recourse to collect the majority of the taxes due.

The auditor then got Bay River to agree to obtain a strengthening bond.

The ATF had formally put Bay River on a tax prepayment basis on February 4, 1986, but the ATF Regional Chief of Compliance orally agreed to continue accepting Bay River company checks. This was a violation of the regulations governing the payment of excise taxes. 27 C.F.R. § 19.519 Even after the ATF was notified on February 13, 1986, that Bay River's company checks were still being returned unpaid, it did not comply with its regulations and enforce the prepayment requirement.

The ATF's Second Audit found repeated violations including Bay River's failure to comply with the prepayment requirement. At the time the Second Audit was conducted Bay River owed in excess of $441,000.00 in delinquent excise taxes. The auditor recommended that Bay River obtain a strengthening bond. Clearly this was the ATF's intent and purpose. By failing to take any action with regard to Bay River's defaults and by requiring a strengthening bond, they hoped to shift the risk of any future losses to Fidelity and Deposit. By failing to disclose Bay River's defaults, the ATF made it possible for Bay River to obtain a strengthening bond. Unless this Court reverses, the ATF will have succeeded in its plan.

The third element in establishing estoppel is that the party asserting estoppel did not have knowledge of the facts. The Government does not dispute Fidelity and Deposit's testimony that it was not aware of Bay River's defaults and bad checks, nor of the violations of statutes and regulations, by both ATF and Bay River, when it issued the Strengthening Bond.

The fourth element is that the party asserting estoppel reasonably relied on the conduct of the other to its substantial injury. Fidelity and Deposit was reasonable in its belief that the ATF would not knowingly and willfully allow Bay River to violate the statutes and regulations concerning the payment of excise taxes. It was also reasonable for Fidelity and Deposit to believe that the ATF would have taken some action when the amount of taxes Bay River owed exceeded $820,000.00 (part of which had been owing for more than a year) especially in light of the fact that Bay River only had $100,000.00 of withdrawal coverage. Silence or a failure to act in the face of a duty to act can be the basis for reliance. *Ohio Casualty Ins. Co. v. United States*, 12 Cl. Ct. 590 (1987). A surety does not contract to assume the risks of unreasonable conduct of a government agent that results in loss to the government. Id.

The fifth element requires a showing that government agents engaged in affirmative misconduct. The District Court paraphrasing *United States v. Fulton Distillery, Inc.*, 571 F.2d 923 (5th Cir. 1978) in its memorandum opinion holds that

> 'The Government's neglect could not have constituted an act which increased the surety's risk and discharged [Fidelity] because the risk of neglect had already been allocated to the surety . . .' The Government owes no duty to a surety for its neglect in this instance."

The actions of the Government go far beyond mere negligence in this case. Bay River was placed on a prepayment basis on February 4, 1986. Although the letter confirming the prepayment requirement expressly states that future tax payments were to be made in cash or by cashier's check, treasury check or money order as required by the federal regulations, the ATF Regional Director of Compliance orally told Bay River that it could continue to pay it taxes by company check.

It is undisputed that, less than 2 weeks after placing Bay River on prepayment, the ATF was informed that yet another Bay River check for payment of excise taxes in the amount of $87,653.59 had been returned unpaid. After

receiving that notice, the ATF did not undertake to enforce the prepayment requirement or make demand on the 1984 Bond. To the contrary the ATF continued to allow payment by company checks so that at the time the Strengthening Bond was approved by the ATF, Bay River had 14 checks for taxes returned unpaid totalling in excess of $820,000.00

The ATF did not inform Fidelity and Deposit of the unpaid taxes nor did it take *any* action against Bay River, even though the ATF audit had concluded that Bay River's financial condition and profit margin made it incapable of paying its taxes. The ATF had already discovered that Bay River was fund floating in order to pay any of its taxes. Knowing this, ATF recommended, in fact, insisted that Bay River obtain the Strengthening Bond. This is the type of *affirmative* conduct that distinguishes the ATF's conduct here from other cases.

The ATF's affirmative acts in requiring the Strengthening Bond, knowing that it had refused to enforce the federal regulations concerning the payment of taxes; its total disregard of the continuing regulatory violations by Bay River and its concealment of Bay River's failure to pay its taxes so that Bay River could obtain a Strengthening Bond certainly constitutes affirmative misconduct on the part of the Government.

III. THE COURT OF APPEALS' DETERMINATION THAT THE DESIGNATION "WITHDRAWAL BOND" ON THE 1984 BOND WAS "HARMLESS SURPLUSAGE" RUNS CONTRARY TO ESTABLISHED RULES GOVERNING THE CONSTRUCTION OF CONTRACTS.

The Fifth Circuit in construing the 1984 Bond considered the designations of the Bond as a "unit bond" and as a "withdrawal bond" and determined that under the federal scheme as set out in the 26 U.S.C. § 5173 "the parties intended that the 1984 Bond provide coverage for both operational and excise taxes to the full amount of that bond," and therefore the designation of the Bond as a withdrawal bond was "harmless surplusage." App. A, pg. 7.

There is no dispute that the designation of the 1984 Bond as a unit bond and a withdrawal bond had to be a mistake. That combination of bonds is not provided for by 26 U.S.C. § 5173. Fidelity and Deposit contends that the 1984 Bond is ambiguous and that the District Court should have denied summary judgment and considered evidence as to the intent of the parties. This position is bolstered by the fact that the District Court found as a matter of law that the 1984 Bond was a $250,000.00 unit bond and $100,000.00 withdrawal bond whereas the Fifth Circuit found as a matter of law that the 1984 Bond was a $350,000.00 unit bond.

Section 26 U.S.C. § 5173 requires that a distiller provide an operations bond and a withdrawal bond or a unit bond. The operations bond and withdrawal bond can be on separate forms, or as the Government concedes, on a single form. The surety can also provide for a unit bond which covers both operations and withdrawals. Subsection (h) of 26 U.S.C. § 5173 provides:

> **(h) Special rules** — For purposes of this section —
>
> **(1) Withdrawal bonds.** In the case of any bond furnished under this section which covers withdrawals but not operations —
>
> **(A)** such bond shall be in addition to the operations bond, and
>
> **(B)** if distilled spirits are withdrawn under such bond, the operations bond shall no longer cover liability for payment of the tax on the spirits withdrawn.

26 U.S.C. § 5173. By designating the 1984 Bond as separate operations and withdrawal bonds Fidelity and Deposit would limits it its withdrawal liability to $100,000.00. It is equally likely that the designation "unit bond" is the harmless surplusage as it is the designation "withdrawal bond."

Neither the District Court nor the Court of Appeals mention in their Opinions the uncontroverted evidence showing that the ATF, which is responsible for approving and enforcing the surety bonds, understood that the 1984 Bond was two separate bonds that limited the withdrawal coverage to

$100,000.00. The ATF audit discusses the withdrawal coverage and includes the auditor's conclusions:

> The proprietor's liability began exceeding his $100,000.00 bond at the end of May 1985 . . . The effect of this is to leave the Government no recourse against a surety for liabilities in excess of $100,000.00 should the proprietor default.

Even in the demand made by the ATF against Fidelity and Deposit in July 1988 they admitted that the withdrawal coverage under the 1984 Bond was limited to $100,000.00. The ATF Chief, Technical Services wrote to Fidelity and Deposit and stated:

> The penalties and interest have not been included for the 1985 and 1986 taxes because the unpaid taxes themselves exceed the $700,000.00 withdrawal bond coverage amount.

(The $700,000.00 is comprised of the $100,000.00 withdrawal coverage and $600,000.00 additional coverage provided by the Strengthening Bond).

Given the obviously conflicting designations in the 1984 Bond the Bond is ambiguous and the United States Motion for Summary Judgment on that issue should have been denied.

CONCLUSION

The Petition for Writ of Certiorari should be granted. The Court of Appeals has created new federal common law which is at odds with existing common law and prior holdings of this Court. Further, the Court of Appeals interpreted the 1984 Bond by disregarding the bond designation to conclude it was a unit bond when, in fact, the bond could have equally been interpreted as withdrawal and operations bonds. The 1984 Bond is ambiguous and a fact issue exists as to the parties' intention. The District Court should, therefore, deny the Motion for Summary Judgment on that issue and heard evidence concerning the parties' intent.

WHEREFORE, Fidelity and Deposit respectfully requests that Writ of Certiorari be granted and that upon due consideration the holdings of the Court of Appeals and the District Court be reversed and this matter be remanded for trial.

Respectfully submitted,

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